

C. HEALTH CARE UPDATE

1. Introduction

This topic consists of a review of recent developments and trends in the health care area. The following discussion is in three sections: hospital reorganizations; executive compensation; and profit-sharing plans. These issues have been discussed in earlier CPE texts; however, developments have occurred in the last year that have a significant impact on the Service's analysis of these tax issues. Other health care related developments, such as finalization of regulations under IRC 501(e) and IRC 513(e) and publication of Rev. Rul. 86-98, are addressed in the Current Developments section of this text.

2. Hospital Reorganizations

As indicated in prior discussions of this subject (see 1983 CPE text, pages 22-28, and 1985 CPE text, pages 191-199), in the early 1980s, the Service started receiving many ruling requests from tax-exempt hospitals proposing to reorganize into multi-organizational systems. We continue to receive a significant number of these requests.

A typical hospital reorganization involves the creation of new entities that will serve as affiliates of one or more existing hospitals exempt under IRC 501(c)(3). In most cases, the hospital will spin-off some or all of its activities which are not directly involved with patient care to the newly-created organizations. For example, the fundraising activities of the hospital could be transferred to one new entity, the management and planning activities to another entity, the laboratory testing services to even another entity, etc. A diagram of a typical reorganization of a single hospital is as follows:

Before Reorganization	H
After Reorganization	P controls H, F, S, R

Key:

H = Hospital

P = Parent - Management & Planning

F = Fund-raising & Endowment Holding

S = Radiology, Laboratory, and Exempt Services

R = Real Property Holding Company

In the above example, newly-created organizations P, F, and S will apply for exemption under IRC 501(c)(3), and R will apply under IRC 501(c)(2). After exemption is recognized, the structural reorganization and the transfers of assets from H to the newly-created entities will take place; endowment funds would be transferred to F, equipment involved with the radiology and laboratory services would be transferred to S, and real property would be transferred to R. Of course, the transfers would not be limited to just property; personnel involved in the various activities would generally also be transferred as a result of the reorganization. After the reorganization, P's function in the new structure would be to formulate policy and to provide overall management for the affiliated group.

The reasons cited most often by the hospital for the restructuring are: (i) to increase management specialization and efficiency; (ii) to facilitate compliance with governmental regulations and reporting requirements; and (iii) to insulate hospital assets from malpractice claims.

The rulings that are usually requested with respect to a proposed reorganization involve:

1. Qualification for exemption of the new entities and the continued qualification for exemption of the hospital after the reorganization;
2. Classification of the new IRC 501(c)(3) entities as public charities under IRC 509(a) and continued public charity status for the hospital; and
3. The nonapplicability of the tax imposed under IRC 511 to any of the attendant transfers or transactions.

After the reorganization diagramed above, H would continue to be carrying out exempt purposes described in IRC 501(c)(3), and would continue to be classified as a public charity described in IRC 509(a)(1) and IRC 170(b)(1)(A)(iii). Rev. Rul. 69-545, 1969-2 C.B. 117. Also, assuming that the usual prerequisites for qualification under IRC 501(c)(3) are satisfied (e.g., the organizational test of Reg. 1.501(c)(3)-1(b) and the notice requirement of IRC 508(a)), P, F, and S would each qualify for exemption under IRC 501(c)(3) by reason of being an "integral part" of the operation of H. Rev. Rul. 78-41, 1978-1 C.B. 148. (In this regard, see the discussion on page 27 of the 1983 CPE text and page 193 of the 1985 CPE text.) Also, because we generally accept the taxpayer's stated reasons for reorganizing as being valid and conclude that the restructuring furthers the exempt purposes of the

hospital, we would find that the transfers of property or funds attendant to the reorganization would not give rise to tax under IRC 511. Therefore, we are left with what has been a troublesome issue in hospital reorganization cases -- determining the appropriate foundation status of each newly-created IRC 501(c)(3) organization.

In the reorganization diagramed above, three new IRC 501(c)(3) organizations were created. Of course, each of these new entities would want to be classified as other than a private foundation under IRC 509(a), thereby avoiding the application of the Chapter 42 provisions. In the case of S, the requirements of IRC 509(a)(2) should be satisfied because the majority of its gross receipts would come from fees charged for services related to exempt purposes, and it should not have any significant amount of investment income. Similarly, F should receive enough of its total support from contributions from the general public to satisfy the requirements of IRC 170(b)(1)(A)(vi). Accordingly, S and F would each qualify for an advance ruling under IRC 509(a)(2) and IRC 170(b)(1)(A)(vi) and IRC 509(a)(1), respectively.

The reorganization diagramed above furnishes an example of a potential obstacle to a successful hospital reorganization. The potential problem is getting P classified as other than a private foundation. Unlike S and F, which each conduct activities resulting in public support from fees for services or contributions, P's management and control activities will not generate support from the general public. Therefore, because P may not be able to satisfy the applicable support test of either IRC 509(a)(2) or IRC 170(b)(1)(A)(vi), and because it is clear that P would not be described in IRC 170(b)(1)(A)(i) - (v) or IRC 509(a)(4), P's only possible escape from classification as a private foundation may be IRC 509(a)(3).

The traditional IRC 509(a)(3) relationship involves a supporting organization that supports the activities of one or more publicly supported organizations described in IRC 509(a)(1) or IRC 509(a)(2). (For a general explanation of IRC 509(a)(3), see the article in the 1982 CPE text on pages 23-39.) However, in many reorganizations, including the one diagramed above, the relationship is reversed -- the supported organizations are the subsidiaries and the supporting organization is the parent. In some cases we encounter even another variation from the traditional IRC 509(a)(3) relationship, that of the parent and one or more subsidiary organizations each seeking IRC 509(a)(3) classification. Thus, two basic questions (discussed in G.C.M. 39508, date May 27, 1986) are raised:

1. Is it permissible under the statute and regulations for an IRC 509(a)(3) organization to serve as the parent of the organization(s) it supports?
2. Is it permissible under the statute and regulations for an IRC 509(a)(3) organization to have an IRC 509(a)(3) parent?

The theory supporting the IRC 509(a)(3) exception to private foundation classification is that a publicly supported organization's control or involvement with a supporting organization will render unlikely the potential for manipulation for private purposes. To this end, the statute requires that an organization meet the three following tests:

1. Organizational and operational test -- IRC 509(a)(3)(A)
2. Relationship test -- IRC 509(a)(3)(B)
3. Lack of outside control test -- IRC 509(a)(3)(C)

Overall, these tests seek to define the extent of control or involvement by the publicly supported organization and the lack of control or involvement by others. Of the three tests, the relationship test of IRC 509(a)(3)(B) is the centerpiece of the statute. This is because the particular relationship that a supporting organization has with one or more publicly supported organizations may determine the ease or difficulty it will encounter in meeting the other tests. Also, as a practical matter, if an organization satisfies the relationship test it could easily amend its organizational document or make other adjustments to remedy any deficiency under either of the other two tests. Accordingly, the relationship test should be considered first.

In order to satisfy the requirements of IRC 509(a)(3)(B), an organization must demonstrate that it stands in one of the following relationships:

- (i) "operated, supervised, or controlled by" a publicly supported organization;
- (ii) "supervised or controlled in connection with" a publicly supported organization; or
- (iii) "operated in connection with" a publicly supported organization.

The above relationships are described in detail in Reg. 1.509(a)-4(g), (h), and (i), respectively. The first two relationships, as their names indicate, rest on a finding of supervision or control. On the other hand, the third relationship ("operated in connection with") is not so concrete, and the regulations require that the presence of such a relationship be established by factors such as "responsiveness" and "significant involvement."

In the reorganization diagrammed above, P as the parent entity could not persuasively argue that it is "operated, supervised, and controlled by" [emphasis supplied] the publicly supported organizations it serves. The relationship contemplated in the statute is one where the publicly supported organization stands in the relationship of parent to the supporting organization, with the supporting organization under the direction of and accountable to the supported organization. Reg. 1.509(a)-4(g).

For a supporting organization to be "supervised or controlled in connection with" one or more publicly supported organizations, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to ensure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. Thus, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations. Reg. 1.509(a)-4(h)(1). Therefore, as a general rule of thumb, a supporting organization would be "supervised or controlled in connection with" one or more publicly supported organizations if at least a majority of the persons who control or manage the supporting organization perform the same function for each publicly supported organization supported or benefited. However, where less than a majority is involved, the commonality must be sufficient so that, when considered together with all the facts and circumstances, there is a clear showing that each publicly supported organization served or benefited can insure that the supporting organization will be responsive to its needs or demands and will constitute an integral part of, or maintain a significant involvement in, its operations.

As a final comment regarding the relationship test, it is theoretically possible that the supporting organizations discussed above could satisfy the third relationship -- "operated in connection with." However, in practice, it may be difficult, particularly in the case of a parent whose activities are so sketchy that it is

difficult to show the actual benefit to the supported organizations as a result of the parent's activities.

Having concluded that the relationship test of IRC 509(a)(3)(B) could be satisfied by a parent supporting organization, we now turn to the question of whether a supporting organization with a IRC 509(a)(3) parent can satisfy the relationship test. For the same reason indicated in the preceding discussion concerning the foundation status of the parent, it is clear that a supporting organization with an IRC 509(a)(3) parent could not be considered to be "operated, supervised, or controlled by" a publicly supported organization within the requirements of Reg. 1.509(a)-4(g). However, again for the same reason as previously discussed, a supporting organization would not be precluded, per se, from having an IRC 509(a)(3) parent, because, if at least a majority of the persons who control or manage each of the two supporting organizations perform the same function for each publicly supported organization within the affiliated group, each of the supporting organizations would be "supervised or controlled in connection with" one or more publicly supported organizations. However, if less than a majority is involved, we would again have to consider the commonality that exists along with the other facts and circumstances in determining whether the relationship test is satisfied.

Turning to the organizational and operational test of IRC 509(a)(3)(A), one argument that might be made that would result in either of the two questions raised above being answered in the negative is that, logically, a supporting organization cannot be exclusively operated to benefit or support publicly supported organizations if it supports an IRC 509(a)(3) organization in addition to the publicly supported organizations. However, example 4 of Reg. 1.509(a)-4(e)(3) would appear to soften this "exclusivity" requirement. In that example, it was concluded that a supporting organization would be considered as operated exclusively to support a publicly supported organization within the meaning of IRC 509(a)(3)(A) even though the organization made a small annual general purpose grant to a non-private foundation that performs a particular function that assists in the overall program of the publicly supported organization.

In conclusion, it is our present view that a supporting organization may satisfy the requirements of IRC 509(a)(3) even though it: (i) serves as a parent of the publicly supported organization(s) or (ii) has a parent that is an IRC 509(a)(3) organization. However, as indicated above, a commonality among the persons in control of the supporting organization and publicly supported organizations will

probably be necessary for the supporting organization to satisfy the relationship test of IRC 509(a)(3)(B).

Hospital reorganization cases often present issues other than those discussed above. For example, many reorganizations involve the creation of taxable subsidiaries. What effect, if any, does this have on the exempt status of the parent organization? For discussion in this regard, see the article in the 1986 CPE text beginning on page 33; G.C.M. 39326, dated August 31, 1984; and G.C.M. 39508, dated May 27, 1986. Although the G.C.M.s cannot be used or cited as precedent, they provide guidance regarding the analysis to be used in determining whether exemption under IRC 501(c)(3) or classification under IRC 509(a)(3) is appropriate in a given case.

3. Executive Compensation

Nonprofit hospitals and other health care organizations must pay salaries to their administrators, officers, and other employees just as similar commercial entities do. Nonprofit organizations can range in size from operations run out of members' homes to trade associations and hospital systems that manage complex operations, with budgets that run in the millions of dollars, and staff sizes to match. Often, staff members will volunteer their time and effort, part-time, to the small nonprofit organization. On the other hand, as a practical matter, corporate officers of the large, complex nonprofit organizations work full-time, with long, arduous work days. Managing the organization is their paid job, and they are not willing to work, and simply cannot afford to work, for free, regardless of the charitable nature of the entity. Just as in large commercial operations in the private sector, upper staff of these large nonprofit organizations command high salaries. As job requirements increase, so does the compensation.

Compensation issues often arise in the context of health care organizations because of the presence of a highly compensated professional staff. Unlike commercial operations, however, to be considered a "charitable organization" in accordance with federal tax laws, hospitals and health care organizations must continue to qualify under the applicable provisions of the Internal Revenue Code and the regulations thereunder. Under IRC 501(c)(3), an organization must be engaged primarily in activities that accomplish one or more exempt purposes in order to qualify as an organization operated exclusively for an exempt purpose. Further, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Thus, when reviewing health care organizations, one issue to keep in mind is whether the amount of compensation paid to their top executives results in prohibited inurement. Hospitals and health care systems generally engage in activities that accomplish charitable and educational purposes. They promote health in the community and educate the public on health matters. However, exempt hospitals are constantly in competition with the private sector and among themselves to retain topnotch, capable administrators, officers, and doctors to staff their operations, especially in light of the increasing phenomenon of multi-organizational hospital systems, as noted in the previous subtopic on hospital reorganizations. As a result, hospital salaries are increasing at a rapid rate, as the organizations and companies try to remain comparable in terms of salary amounts offered. Nonprofit health care organizations are discovering that they too must meet these rising salaries or lose their best employees to other organizations or commercial hospitals. Yet, as stated, exempt hospitals must qualify under the Code provisions, and the question arises regarding when salaries paid to executives are too high to be reasonable, resulting in inurement or private benefit to these executives.

A. Reasonable Compensation

It is a well-established principle that the payment of reasonable salaries to managers, officers, or other employees does not constitute inurement of net earnings to the recipient, and does not defeat exemption of an otherwise exempt organization. See, e.g., Mabee Petroleum Corp., v. United States, 203 F.2d 872 (5th Cir. 1953); Birmingham Business College, Inc., v. Comm., 276 F.2d 476 (5th Cir. 1960); and B.H.W. Anesthesia Foundation, Inc. v. Comm., 72 T.C. 681 (1979). The clear implication of this principle, however, is that if an executive's salary is found to be excessive and unreasonable, inurement of corporate net income would result so as to disqualify the organization as tax-exempt. Mabee Petroleum, *supra*, and Birmingham Business College, *supra*.

How does one determine that officers are receiving a "reasonable salary?" Where a question arises regarding an apparent "excessive" salary paid to a health care organization's executive, analyze all the facts and circumstances surrounding the organization's operations and decision-making, as well as the role the affected executive plays in the organization. In other words, a determination of "reasonable salary" is a facts and circumstances test. Certain specific factors to consider in determining reasonableness of compensation have been discussed in various revenue rulings, court cases, and general counsel memoranda. These specific factors, set out below, are not all inclusive, and other circumstances that may play

a part in the salary amount offered by hospital systems to its executives should not be overlooked.

One of the most important factors to consider is whether the agreed upon compensation has been the result of arm's-length negotiation between the parties. Another factor to consider, closely related to the first, is the extent of control by the party receiving the compensation over the exempt organization, or in the case of executives, over the compensation process.

Rev. Rul. 76-91, 1976-1 C.B. 150, referred to these two elements in its discussion regarding fair market value presumptions when an IRC 501(c)(3) purchaser of property is closely related to the seller. Although the ruling is not directly on point, the principle enunciated is applicable to our compensation issue. Rev. Rul. 76-91 indicated that a presumption of fair market value exists where negotiations are at arm's-length and the seller (equated here to the executive officer receiving the compensation) is independent from, and does not control, the purchaser (analogized here to the exempt organization).

In practical terms, arm's-length negotiations and extent of control exercised are complementary factors and need to be examined as one. They can be determined by examining the levels and types of review over the salary determinations or by examining the relationship between the individuals responsible for setting or reviewing the compensation level, and the recipients. Regarding the levels and types of review, for example, a factor to consider is whether the organization employs an independent auditor, such as an accounting firm or a community-based committee, to review compensation levels. A circumstance demonstrating lack of arm's-length bargaining would be a situation where the executive whose salary is questionably high has provided the total administration for compensation levels, or has intimate working knowledge of the compensation process and considerable influence over the parties responsible for fixing his salary.

A conclusion similar to that reached in Rev. Rul. 76-91 was reached in Rev. Rul. 69-383, 1969-2 C.B. 113, in which a third factor was also discussed. In that ruling, a tax-exempt hospital entered into a written agreement with a radiologist after arm's-length negotiations. The ruling concluded that the agreement between the hospital and the radiologist did not result in inurement. The reasons cited were first, the agreement was negotiated on an arm's-length basis. Second, the radiologist did not control the hospital. Third, the amount the radiologist received was reasonable in terms of the responsibilities and activities he assumed under the

contract. This third factor is explained at greater length in the revenue ruling as follows:

"The amount received by the subject radiologist under the contract described above is not excessive when compared to the amounts received by radiologists having similar responsibilities and handling a comparable patient volume at other similar hospitals."

In other words, examine the extent to which comparable services would have a similar cost if obtained from an outside source in an arm's-length negotiation. It would also be advantageous to examine comparisons of amounts received by executives commensurate with their experiences or reputations in the field of hospital administration. Just as in the private sector, experience and reputation play almost as important roles in salary offers as do responsibilities assumed. The organization may be able to demonstrate comparisons from accounting firm studies, industry studies, governmental studies, or their own research.

A fourth factor, considered by the court in Enterprise Ry. Equip. Co. v. United States, 161 F. Supp. 590, 142 Ct. Cl. 192 (1958), is whether the salary would qualify as an expense deduction under IRC 162(a). The court concluded that salaries and contributions deemed reasonable as a deduction from gross income under IRC 162(a), and its predecessor, section 23 of the Internal Revenue Code of 1939, would be equally reasonable for the same corporation under IRC 501(c), and its predecessor section 101. The court viewed the same test of reasonableness as applicable with respect to compensation for personal services rendered under both sections. The court cited this premise again in Founding Church of Scientology v. U.S., 412 F.2d 1197, 1200 (Ct. Cl. 1969), cert. denied, 397 U.S. 1009 (1970), in which it construed the "inurement of earnings" clause in IRC 501(c)(3) to permit an organization to incur ordinary and necessary expenditures in the course of its operations without losing its tax-exempt status. To the court, deductibility of salary and reasonableness of compensation are intertwining concepts.

G.C.M. 38905, dated June 11, 1982, also discusses factors to analyze in determining what is "reasonable compensation." While the G.C.M. is disclosed to the public, it may not be cited as authority for other cases, and is discussed here for training purposes only. Although the G.C.M. deals with a much more troublesome compensation arrangement, which will be touched upon later, namely, a compensation arrangement based upon a percentage of an exempt organization's

net asset value, it nevertheless discusses certain general criteria related to determining the reasonableness of compensation.

The G.C.M. reiterates some of the criteria discussed above, including the presence of a completely arm's-length contractual relationship, with the employee having no participation in the management or control of the organization. While it is impossible to expect executives not to have management capabilities and control responsibilities, this factor can be viewed as relating to control over the compensation decisions when referring to executive compensation.

Another item noted in the G.C.M. deals with whether the payments serve a real and discernible business purpose of the hospital system independent of any purpose to operate the organization for the direct or indirect benefit of the employee. This second factor from the G.C.M. correlates to the comparability factor in Rev. Rul. 69-383 in that hospitals can have a real and discernible business purpose in desiring to fairly compensate employees for their performance and to retain them when faced with greater compensation paid by comparable and competing institutions.

A third element listed in the G.C.M. requires that the amount of compensation not be dependent principally upon incoming revenue of the exempt organization, but rather upon the accomplishment of the objective of the compensatory contract. In the context of "reasonable magnitude of compensation," this factor emphasizes that the salary level should be based mainly on how effectively and efficiently the executive performs his duties and runs the hospital operations in order to further the hospital's charitable and educational purposes.

The fourth condition suggested in the G.C.M. enlists a review of the actual operating results of the organization to reveal any evidence of abuse or unwarranted benefits. For example, in the G.C.M.'s factual situation, an analysis of the operating costs and revenue received compare favorably with those of similar organizations, and also do not indicate excessive revenue to the executives through noncash benefits. The receipt of unreasonable noncash benefits or other hidden monetary operations results in inurement of the organization's net earnings to its executives to the same degree as excessive salary. New organizations may not have actual operating budgets to review, but proposed budgets and statements from the organization can serve in such a case.

The final factor tendered by the G.C.M. which can be applicable to reasonableness of compensation is the presence of a ceiling or reasonable

maximum which helps to avoid the possibility of a windfall benefit to the executive, especially one based upon factors bearing no relationship to the level of service provided. The ceiling or maximum could be set by board of directors resolution prior to the hiring of an individual to serve as executive, by a formula enunciated in the organization's by-laws, or established by independent auditor opinions. To the extent that the amount of services required of an executive or other manager is positively correlated with the value of assets managed or other duties, the effect of any windfall would be offset. Although these last three factors relate more closely to compensation based on a percentage of net value of the organization and noncash benefits, they also can be utilized to further analyze compensation levels in general.

These factors were again analyzed in G.C.M. 39498, dated April 24, 1986, and led to the conclusion that the physician recruitment incentive program described in the G.C.M., which included the payment of a guaranteed minimum annual income for two years with no obligation to repay the subsidies out of income earned after the contract period, constituted direct private benefit to the physicians resulting in inurement of the hospital's net earnings. The facts established that, in setting the amount of income, the hospital officials considered how much a physician in a particular area of medical specialization could earn during a year, and the hospital's need for a physician in that area of specialization at a particular level of experience.

The G.C.M. started from the premise that a hospital can offer incentives and inducements to attract qualified physicians needed in a particular area of specialization to enable the hospital to provide quality health care. It is a discernible business purpose for the hospital to consider various factors in determining compensation offers sufficient to attract needed qualified physicians, such as the reluctance of a physician to initiate or relocate his or her practice in an unfamiliar area, and the competitive recruitment efforts of other hospitals. Thus, the hospital's operation of a physician recruitment program with the added benefit of a guaranteed minimum annual income feature for the first two years of a new physician's practice does not appear on its face to pose any obstacles to continued exemption for the hospital.

The G.C.M. noted, however, that the amount of subsidies to be paid in this situation bears no discernible direct relation to the value of a particular physician to the hospital, nor is it dependent upon the accomplishment of the objective of the compensatory contract. The subsidies may vary in amount based not on factors directly related to benefits to the hospital, including increased efficiency or

enhanced productivity for the hospital because of the presence of the physician in the hospital's medical service area, but rather on factors that relate principally to the physician's performance in his or her "private medical" practice. In other words, the benefit to the particular physician from the subsidy arrangement outweighs the benefit to the hospital from the doctor's relocation.

The G.C.M. also stressed that the arrangement lacked a ceiling on amounts of subsidies to be paid (other than the total annual income guaranteed), or of any requirement that the physician, who need not repay a subsidy, provide further services or continue to benefit the hospital after the expiration of the two year contract period. The absence of these factors could lead to a windfall benefit to the physician that is not quantitatively incidental to the hospital's attempt to further the promotion of health through its efforts to recruit the particular physician. As the G.C.M. pointed out, although a hospital may offer a one-time recruitment bonus or incentive the amount of which is determined not by reference to services to be rendered, but by reference to the value assigned to recruiting a particular physician to its medical service area, in the situation described, two newly recruited physicians of comparable worth each could receive different subsidies which do not relate to identical values placed by the hospital on recruiting them.

Thus, the G.C.M. determined that the amounts to be paid (and possibly not repaid) as subsidies may fall outside the range of reasonable compensation, and result in inurement of the hospital's net earnings to the recruited physicians.

B. Contingent Compensation Arrangements

As pointed out in G.C.M. 38905, the magnitude of compensation is only one method of violating the prohibition against inurement under IRC 501(c)(3). Attention must also be focused on the overall interrelationship between the parties involved.

Under direct compensation arrangements where the exempt organization pays the employee in return for services provided directly to it, the functions performed by the employee are directly aimed at achieving the exempt purposes. The magnitude of salary in a direct compensation arrangement has to be of an excessive nature before a possible inurement problem exists. A health care organization can generally show, through facts such as those discussed above, either that the salary level indicated is necessary to continue operating with capable management in order to further their exempt purpose, or that adequate safeguards have been instituted by the organization to assure no windfall to the administrator

or officer not commensurate to service required. In contrast, where the given method of compensation establishes a relationship between the parties which is competitive, in the sense of encouraging performance that conflicts with the exempt organization's overall goals, prohibited inurement is a more likely result, and the arrangement should be examined all the more closely.

In this regard, contingent compensation arrangements frequently create a conflict between the personal interests of employees and the interests of the charitable employer. As pointed out in G.C.M. 38905, "when compensation is determined as a percentage of net earnings, the interests of affected employees may be enhanced by an increase in net earnings through the manipulation of receipts and expenditures (e.g., by an increase in the price or a reduction in the cost of the goods or services provided by the charitable organization) while possibly diverting from the effective achievement of the charitable organization's exempt purposes (e.g., by a reduction in either the number of potential charitable beneficiaries or the quality of the goods or services by the charitable organization)."

This is not to imply that a salary based on net earnings is per se improper, however. Prohibited inurement would result from such an arrangement only when all the facts and circumstances surrounding the relationship indicate a conferral of private benefit without a corresponding achievement of an exempt purpose. The compensation arrangement can reflect a low potential for substantial conflicts of interest if the plan is adequately limited and safeguarded against abuse. The Service recognizes that when there are adequate safeguards, benefits derived from incentive compensation plans accrue not only to the affected employee, but also to the charitable employer through increased productivity or cost stability, thus adding to, rather than detracting from, the accomplishment of their exempt purposes.

Contingent compensation arrangements differ from profit-sharing benefits that will be discussed in the next subtopic. Participation by employees in a profit-sharing plan is generally a type of benefit offered to employees in addition to direct salary payments, whereas a contingent compensation arrangement represents the basic salary payment itself. In addition, a contingent compensation arrangement is generally based on net asset value of the organization or company, which covers all assets owned by the organization (such as properties) as well as net receipts received. It does not look toward the "profits" made.

The factors outlined above which indicate whether the salary level is reasonable also indicate whether a contingent compensation arrangement is

adequately safeguarded. For instance, the charitable organization could demonstrate an arm's-length relationship between it and its highly paid executives by showing strict division of normal management and control of operations by the executive and of the management and control over the executive's compensation. Second, the percentage compensation arrangement could be shown to serve a real and discernible business purpose independent of any private benefit purpose through a demonstration that such an arrangement is customary and prevalent in the particular industry or in the geographic area, and that this pervasive use necessitates the use of percentage compensation agreement to retain or acquire suitable, capable managers or other employees. The organization alternatively might show that the complicated level of services or types of services (such as investment management) required to be performed by the executive correlates to the amount of compensation paid and to its contingent arrangement, such that benefits accruing to the employee would be offset by benefits accruing to the organization. Also, the contingency arrangement itself could show a correlation to services performed, such as compensation based not on incoming revenue alone, but rather on net asset value of the organization. Finally, safeguards or proscriptions could be inserted in the health care organization's creating documents to prevent abuse of unwarranted benefits and to avoid a windfall to the officers.

Overall, in the case of executives with high salaries or salaries based on a contingent arrangement, the facts and circumstances should not reflect a significant incentive for the executive to promote his own interest at the expense of the charitable endeavors of his exempt employer. It should be kept in mind, however, when reviewing salary levels or arrangements paid to key personnel of hospitals or other health care agencies, that although salary levels may appear at first glance to be too high to be reasonable, the factors outlined above should be considered prior to making any conclusions. The economic environment in which health care organizations are operating has highlighted compensation issues. Trends such as the increasing reorganization of hospitals into complex health care systems tend to have the effect of increasing the responsibilities of officers causing an increase in compensation. Another trend is the expanding industry-wide use of incentive compensation arrangements, such as noncash benefits and profit-sharing plans.

4. Profit-Sharing Plans

Profit-sharing plans are attractive to health care administrators for two reasons. They promote cost containment and they assist the organization in attracting and retaining capable employees.

In the past, the Service has dealt with profit-sharing plans and exempt organizations in the context of whether an exempt organization can have "profits" and whether inurement of the exempt organization's income to its employees was occurring. The Tax Reform Act of 1986 has resolved some of the major problems in this area by providing statutory rules. The new provisions were enacted in order to address a problem that represented a potential conflict between economic necessity and the legal requirements for exemption. Escalating operating costs in the health care industry forced health care providers to adopt measures for cost containment. Profit-sharing plans were attractive because they were thought to promote cost containment. The theory was that profit-sharing would be based on the increase in revenues over the prior year or some other base line. The increase in revenues would reflect an increase in employee productivity. The increased productivity would aid the organization in attaining its goal of cost containment.

Municipalities and other governmental units which operated hospitals could provide their employees with profit-sharing plans under IRC 457. Commercial providers could offer their employees IRC 401(a) and IRC 401(k) profit-sharing plans. Under IRC 401(k), employees could exercise a cash or deferred option. The deferred option was especially attractive to the more highly compensated employees such as administrators and department heads. However, the Service had taken the position that an exempt organization's profit-sharing plan could violate the proscription against private inurement. See, for example, G.C.M. 32518 dated February 22, 1963; G.C.M. 35869 dated June 21, 1974.

These problems were clearly defined in a case presented to Chief Counsel. Chief Counsel resolved the technical issues in G.C.M. 38283 dated February 15, 1980. The case involved a trust which provided benefits to participating employees of an exempt hospital. The trust was qualified under IRC 401(a).

G.C.M. 38283 acknowledges that Chief Counsel had previously taken the position in G.C.M. 35865 that the profit-sharing plan would disqualify the hospital from exemption under IRC 501(c)(3). This conclusion was based on two grounds: (1) A nonprofit organization does not have profits in the sense of having excess funds available for distribution to private individuals or shareholders. (2) Distributing a portion of the organization's net proceeds to its employees would violate the prohibition against private inurement.

The G.C.M. addresses the first proposition by giving less weight to the "semantic anomaly" inherent in the concept of profit being produced by a nonprofit organization. It then addresses the principal issue. Can the hospital use its profits to

fund a profit-sharing plan for its employees without running afoul of the prohibition against private inurement?

The G.C.M. reasons from the premise that payment of reasonable compensation to employees is not inurement. Therefore, the exact form of the compensation package is not critical. What is critical is whether the package as a whole produces total compensation for each individual which is reasonable in amount. Since both for-profit and exempt organizations are bound to the same standard -- reasonable compensation -- it would be appropriate to apply the same standards to both. However, applying those standards, i.e., a facts and circumstances approach, would be as difficult in the exempt sector as it has proved to be in the private sector.

The G.C.M. notes that employee benefit trusts of private sector employers have been required to meet the standards of various provisions of Subchapter D of Chapter 1 and Chapter 43 of the Code, as well as those of Title I of P.L. 93-406, The Employee Retirement Income Security Act of 1974, as amended. The incentive for qualification of a plan is favorable tax treatment for the employer, a benefit not entirely dissimilar from tax exemption for an exempt organization. While the Code's standards were designed with the primary goal of protecting employees, they nonetheless offer an existing, independent standard which can be applied to the plans of exempt organizations. Given the complexity of the issues the Service would otherwise have to consider using a facts and circumstances test, the G.C.M. concludes that it is better to allow the standards to govern both exempt and nonexempt organizations' profit-sharing plans. Therefore, the conclusion of the G.C.M. is that an exempt organization will not jeopardize its status by adopting a qualified profit-sharing plan for its employees.

The position taken in G.C.M. 38283 appeared to be responsive to both the problem of maintaining a competitive position for the exempt organization and the problem of finding a workable objective standard for the Service to use in testing the inurement potential of an exempt organization's profit-sharing plan. It did not, however, put to rest the issue of profit-sharing and exempt organizations.

While the Service was considering the issues presented, Congress began revising portions of the Code dealing with pension plans. The revisions dealing with the profit-sharing plans of exempt organizations are contained in the Tax Reform Act of 1986. Three sections of the Act concern the treatment of qualified profit-sharing plans of exempt organizations.

Section 1107 states that exempt organizations can have qualified IRC 457 plans that are adopted after December 31, 1986. IRC 457 plans are the unfunded deferred compensation plans which, under prior law, were already available to employees of state and local governments. The new law extends similar treatment, after December 31, 1986, to IRC 457 plans of exempt organizations.

Section 1116 of the Act provides that exempt organizations cannot have qualified IRC 401(k) plans that are adopted after July 2, 1986. IRC 401(k) plans are those that provide a cash or deferred payment option.

Section 1136 provides that the determination of when an employee plan is a profit-sharing plan will be made without regard to current or accumulated profits and without regard to whether the employer is a tax-exempt organization. Section 1136 is effective for plans years beginning after December 31, 1985.

Consequently, the statutory changes enacted in the Tax Reform Act appear to have resolved the long-standing concerns of the Service regarding profit-sharing plans and exempt organizations, particularly organizations exempt under IRC 501(c)(3).

5. Conclusion

The preceding discussion has focused on three areas affecting health care organizations. The issues discussed and the analysis presented make it clear that such organizations are taking increasingly aggressive and creative approaches to their operations in response to a rapidly changing economic environment. It is likely that further significant tax developments will occur.